HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

B-71 Cannon HOB ■ Washington, DC 20515 ■ 202-226-7200 ■ www.house.gov/budget_democrats

April 8, 2003

Proposed Budget Deficits Have Serious Consequences

Dear Colleague:

Later this week, the House is likely to consider this year's budget resolution conference report. The attached article by Jeff Madrick from this Sunday's New York Times Magazine reminds us of some of the key issues that are at stake.

- ***Budget Faces Deep Deficits*** — In the last two years, a ten-year projected surplus of $5.6 trillion has been wiped out. The Administration now proposes a budget that would be more than $2 trillion in deficit over the same time period — even without the cost of the war or other significant costs omitted from the Administration's budget.

- ***Long-Term Deficits Bad for Economic Growth*** — Despite the Administration's insistence that deficits are not worrisome, mainstream economists agree that structural long-term deficits of the type proposed by the Administration (as contrasted with cyclical short-term deficits) will slow economic growth over the long run.

- ***Nation Should Be Preparing for Baby Boom Retirement*** — The Administration's proposal to worsen the deficits comes at a time when we should instead be paying down the national debt to prepare for the retirement of the baby boom generation, which begins in just five years.

- ***Current Budget Path Leads to Serious Consequences*** — The country cannot sustain substantial deficits indefinitely. If we continue to run deficits of the magnitude proposed by the Administration, the shortfalls eventually will have to be eliminated by one or more unpalatable policy choices including substantial cuts to key government services such as Social Security.

Last week, at the only full meeting to date of the conference committee on the budget resolution, I proposed that lawmakers from both sides of the aisle roll up our sleeves and work out a budget plan that would return the budget to unified balance by 2010 and to on-budget balance by 2013. I believe that such a budget would deserve bipartisan support because it would get us back on a path of fiscal responsibility, economic growth, and preparing for the retirement of the baby boom generation. If, on the contrary, we are presented with a budget conference report that shares many of the flaws of the Administration's plan, I encourage you to bear in mind the issues raised in the attached article.

Sincerely,

John M. Spratt, Jr.
Ranking Democratic Member

The New York Times
nytimes.com

April 6, 2003

The Iraqi Time Bomb

By JEFF MADRICK

The denial of economic reality that permeated Wall Street a few years ago has now migrated to Washington. On Wall Street, when companies did not generate the promised profits to justify the bubble in stock prices, many analysts told investors that profits did not matter. A new economy would be gauged by other measures, they insisted. Today, in similar fashion, as the federal budget has plunged into the red over the past two years, President Bush's economic team is telling the nation that deficits no longer matter.

At first, perhaps, the claim seemed plausible. Damage to the economy was not yet evident. And I, for one, am not a deficit hawk. At times, deficits are necessary to stimulate economic growth, and their dampening impact on private investment is occasionally exaggerated. But because of the Bush administration's policies and a weak economy, deficits are now approaching unmanageable levels, as they did in the 1980's. In fact, the federal government's fiscal health has deteriorated at a pace so stunning that few have yet caught up with the facts.

Here are some of those facts. Even without a war, the budget deficit would have exceeded $300 billion this year -- just three years after the budget experienced a surplus of nearly $240 billion. (This was in the midst of a four-year run of substantial surpluses.) But with war costs escalating and revenues falling as a result of the flat economy, this year's deficit could rise to $400 billion. In fiscal year 2004, it is likely to be higher.

The president has asked Congress for $75 billion to finance war-related costs, but many think a more realistic estimate of the combined costs of war and reconstruction will be closer to $200 billion. More alarming is the decline of government revenues over the long run. Instead of generating $5 trillion to $6 trillion in surpluses over 10 years from rising tax revenues on growing incomes, the government will now probably come up nearly $2 trillion short through 2013. That recession and slower growth have shrunk tax revenues is predictable enough. But the sinking stock market has taken more of a toll than expected: there are no more outsize capital gains to tax. These yielded fat revenues in the late 1990's, when stocks were soaring, exaggerating the fiscal health of the nation. Now the train is running in reverse.

Finally, the Bush tax cuts have made long-term financial prospects significantly worse. Occasionally, tax cuts make sense. But the $1.4 trillion tax-cut package passed in 2001 would have been more productive if it had been temporary and applicable to more taxpayers. Instead, it was skewed to the rich (who are prone to save rather than spend) and will be permanent -- far from disappearing should the economy improve, the tax cut will grow larger. The administration proposed a second major tax cut in early January, estimated to cost $726 billion over 10 years, and it appears to be even less effective as a near-term stimulus: more than half of the total results from the elimination of taxes on dividends, an idea raised at Bush's economic summit in Waco, Tex., last August by a stockbroker, Charles Schwab. In addition, the Bush administration followed up this tax plan with a new budget that would extend the

2001 cuts three years past their expiration, costing another $600 billion.

The Senate has since voted to reduce the $726 billion budget request by half, but last week it was still far from clear that this change would prevail, given that the House passed a budget resolution that assumed the president's tax cuts.

The consequence of all these steps? Budget deficits as far as the eye can see. When Bush took office, his budget team estimated there would be a cumulative surplus of some $5.6 trillion over the next 10 years. Now, in light of the 2003 tax cuts and the new Bush budget, the Congressional Budget Office, the nonpartisan economic research arm of Congress, calculates that a long-term surplus will turn into a $1.8 trillion deficit between 2004 and 2013.

Unfortunately, economists outside the government estimate that the deficit will be even larger. William Gale and Peter Orszag of the Brookings Institution figure the deficit is likely to approach $2.5 trillion. The Wall Street economists William Dudley and Edward McKelvey of Goldman Sachs say that the deficit will exceed $4 trillion by 2013.

The timing of this looming deficit could not be worse. The retirement of baby boomers is about to begin en masse. In 10 years, the costs of Social Security and Medicare will start rising rapidly. By the 2020's, these costs will begin to reach roughly 12 to 15 percent of gross domestic product, compared with about 6.8 percent today. To put this in perspective, consider that all current federal expenditures now come to only 20 percent of G.D.P.

The concern about large deficits is that they reduce long-term economic growth and produce even less revenue for social programs. When large enough, government deficits require so much federal borrowing that they can displace private investment and push up interest rates on mortgages, consumer credit and business borrowing to levels that thwart home buying, consumer purchases and capital investment. (If interest rates should stop falling, home refinancing, which has recently been a principal source of more money for consumers, will be less attractive.) Big deficits also make the U.S. economy especially vulnerable to the loss of capital investment from overseas. Because Americans save so little, and because the nation imports much more than it exports, the United States must attract close to $500 billion of foreign capital annually to finance its growth. High budget deficits could easily reduce the confidence of foreign investors, who already own 36 percent of U.S. government debt. If they sell some of those securities, they will drive down the value of the dollar and U.S. investments will become even less attractive. Over the last year, the dollar has already fallen by 20 percent against some major currencies.

The slower growth that results from large deficits affects everybody. It leads to lost jobs, lower wages and fewer business opportunities. A return to the sluggish economy of the 1980's and early 1990's is not only possible but likely.

Straitened conditions are being felt already. States, starved for revenues because they cannot borrow to make up for the deficits caused by the economic downturn, are now cutting education, health and poverty programs aggressively. State and local governments are also complaining that money promised by Washington for homeland security has not arrived. And the president recently told the states that there's no extra money for them.

Given the pinch, how can we explain the administration's fiscal choices? Some economists in the Bush camp claim that lower tax rates and the elimination of taxes on dividends will both motivate people to work harder and investors to invest more. The economy will grow faster than traditional economic models anticipate, producing tax revenues that will reduce projected budget deficits. But most economists say there is a large measure of ideological wishful thinking here, reminiscent of the supply-side economists who advised President Reagan. Bush's economic advisers argue, for example, that the dividend tax cuts may generate more growth than any conventional economic model can predict by making investment in stocks more attractive; rising stock prices will in turn encourage investment. Few economists agree, however, that eliminating dividend taxes will have more than a modest impact on stock prices. And even a 20 percent boost in stock prices from current levels does not restore them to their recent highs.

Narrow politics, of course, can partly account for the Bush administration's tax proposals. The tax cuts disproportionately benefit the wealthy, which, after all, is Bush's natural political constituency. But Bush's policies may, in fact, best be explained by another, more radical agenda. Extensive tax cuts will require Congress to limit the growth of social programs and public investment and undermine other programs altogether. If that is your vision of the best direction America can take, the strategy makes some sense. So, we were wrong about how dividend tax cuts stimulate growth, you can almost hear the Bush advisers thinking. No problem. Rising deficits will inevitably force Congress to starve those "wasteful" social programs. The prospective high deficits may even make it imperative to privatize Social Security and Medicare eventually. Social spending is the problem, goes the argument, not tax cuts.

The Bush administration has been inconsistent about its economic rationales since its earliest days in office. First, President Bush justified his $1.4 trillion tax cut in 2001 by claiming the government should return surpluses to taxpayers when the economy is strong. He found a convincing ally in Alan Greenspan, chairman of the Federal Reserve, whose influence was critical to the tax cut's passage. Then, as the economy appeared to be weakening, Bush argued that a tax cut was needed for an entirely different reason. It would stimulate the weak economy inherited from Bill Clinton. This made sense, but as noted, the tax package was not a short-term stimulus package.

When, by early 2003, there was no escaping the fact that the federal budget would remain in long-term deficit, the Bush administration's budget office did not issue the customary 10-year forecast. Instead, it only forecast a five-year budget. Beyond that, the Bush team said, economic events were too uncertain.

The Congressional Budget Office, however, does not enjoy such flexibility. It produced its standard 10-year outlook, which spelled out the obvious. But to give the Bush administration its due, a more recent C.B.O. analysis also tried to take into account the possible growth incentives of the tax cuts. Based on at least seven different approaches to how government policies may affect future finances, none of the Congressional Budget Office's economic projections eliminated the future deficit. To the contrary, they all clustered around the original $1.8 trillion deficit figure that the office had calculated earlier. (The number of possible approaches to these forecasts alone suggests how little is truly known about the impact of such changes.) There would be a significant budget deficit every year through at least 2013, and, by implication, for many years after.

Can we live with these new deficits? If they remain as low as the budget office predicts, they will come to less than 1 percent of gross domestic product in the last few years of the forecast. Even so, this will probably impede economic growth. And by 2014, when baby boomer liabilities begin to rise rapidly, there will be no easy way to finance them. As Lee Price, the chief economist of the Senate Budget Committee Democrats, points out, by 2010 or even earlier, the nation will have to start gearing up to pay for the baby boom retirement. This will require either a very large tax increase or substantially reduced benefits. The financial markets will force the government to become more responsible about spending, or interest rates will be driven to damagingly high levels.

And that's based on a moderately optimistic forecast, one that assumes the economy grows at a healthy rate. Specifically, it assumes that productivity -- the output per hour of work that is the primary source of growth -- will rise by 2 percent year. That is a rate slower than that of the booming late 1990's, but it is considerably faster than the average pace between 1973 and 1995.

The C.B.O.'s projection incorporates only changes proposed in the Bush budget. But other costly adjustments will be necessary. Most important, tax cuts will subject as many as 40 million taxpayers to the higher alternative minimum tax. (The A.M.T. forces taxpayers, whose payments would be very low on account of large deductions, to pay at least a minimum rate.) The government will almost certainly change that, further reducing tax revenues. Also, some expiring tax provisions will surely be extended. Gale and Orszag of the Brookings Institution find that these factors add another $700 billion to the 10-year deficit. This does not include war expenditures.

Dudley and McKelvey of Goldman Sachs reach their estimated $4.2 trillion 10-year deficit by adding war and reconstruction estimates. They also expect that Congress will pass a substantially higher provision for reimbursement of prescription drug costs under Medicare than Bush has proposed, and that economic growth will be slower than anticipated.

These and several other realistic assumptions result in a federal deficit that is unquestionably a terrible burden. The deficits will require so much borrowing that the Goldman economists figure that the size of the federal debt will rise from 33 percent of gross domestic product to 49 percent. This, even more than annual deficits, alarms economists. The federal revenue needed just to pay the interest will be enormous.

Even this estimate does not take into account a realistic view of the costs of war and a new foreign-policy doctrine that could mean military involvement elsewhere. The $75 billion in appropriations that the Bush administration recently asked for covers only the first six months in Iraq. As for the costs of peace, it is hard to make any sensible assessment. Some military experts claim that the presence of only 50,000 troops will be required. Gen. Eric Shinseki, the Army chief of staff, estimates that as many as 200,000 troops will be needed. That could well cost $50 billion a year. There are wide-eyed hopes that Iraq's oil revenues will defray most of the cost of reconstruction, but it will take several years to bring production to its full potential, as well as billions of dollars -- and that's assuming there is complete peace. Some put the estimates of maintaining peace and building democracy in the hundreds of billions of dollars.

And implementing the new world vision Bush has discussed recently will require still more money. An ongoing presence in the Middle East beyond Iraq will soak up additional billions; potential crises in Korea and elsewhere will demand expensive attention. As I understand it, since even before the war started, the Defense Department has been spending money so fast it can't keep track of it. In sum, the new defense commitment looks open-ended.

The budget resolution the House passed last month makes clear the dollar amount of cuts in domestic programs that would have to be made in order to retain something close to fiscal balance in Washington in 10 years. They will involve deep cuts in programs from Medicaid to school lunches to college loans to, perhaps most cynically in the current environment, veterans' benefits. The Center on Budget and Policy Priorities calculates that reductions in mandatory programs for the elderly, veterans and the poor would come to $265 billion over 10 years. Another $210 billion would be lopped off of discretionary programs. The total of $475 billion is about equal to the tax reduction the president is requesting for the top 1 percent of earners in America.

To make this politically palatable, the reductions would be phased in. Average reductions would be only 1 percent in the first year, but they would rise rapidly and would average 4 percent over 10 years. In the worst years, the budget for Medicaid would be cut by 7 percent.

But the House bill is based on the C.B.O. projections. If other economists are right, and the deficits are considerably larger, still greater cuts will be required to balance the budget over time -- in fact, perhaps double the amount. The Bush administration insists that it can live with the budget deficits and still maintain many of these programs. Denial has become almost a ritual. But it cannot have anticipated how quickly America's finances have turned to red, and it is not very likely that it is prepared to face the reality that the financial markets, if not Congress, will eventually impose on it. If there is no growth miracle on the horizon that would raise government revenues, the Bush administration's options will be limited not only domestically, which may be part of its design, but also militarily. The administration may well be compromising its own dearest goals.

The longer we wait, the harder it will be to correct the nation's finances. Most of us will be hit from both ends. Incomes will not rise the way they did in the late 1990's, and it will be difficult to save for retirement. The rising costs of education and health care will be harder for the typical family to meet. Meanwhile, government will not have the money to help. Programs may be cut across the board. And consider what was not accomplished in the 1990's, despite the nation's prosperity. More than 40 million Americans still have no health insurance. The United States has the highest proportion of children born into poverty in the developed world. The quality of education remains grossly unequal. Even two-worker families cannot afford quality day care. Much remains to be done.

There is time for a course correction. But the longer the nation waits, the harder the problems will be to fix. Forecasting the economic future, as everyone knows by now, is no sure thing. But the federal government simply cannot indefinitely spend so much more than it takes in. At some point, the nation will either raise taxes significantly or make painful cuts in cherished federal programs.

But as long as the full consequences of Bush's extravagance are not immediate, and war limits serious public criticism, the president may for now get away with promising guns and a little butter. And we will all pay for it.

Jeff Madrick is a contributing economic columnist to The New York Times, editor of Challenge Magazine and the author of "Why Economies Grow."